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CPI Competition Policy Institute

October 6, 1997

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Mr. William Caton
Secretary
Federal Communications Commission
1919 M St. N.W.
Washington, D.C. 20554

EXPARTE: Remand Issues in the Payphone Proceeding
CC Docket No. 96-128

Dear Mr. Caton:

On Thursday and Friday, October 2 and 3, 1997, Debra Berlyn and John Windhausen of the Competition Policy Institute (CPI) met with the following individuals to discuss the above-captioned matter: Richard Metzger, Brad Wimmer, and John Muleta of the Common Carrier Bureau, Kathy Franco of Commissioner Chong's office, and Paul Galant of Commissioner Quello's office. In addition, John Windhausen had a telephone conversation with Jim Casserly of Commissioner Ness's office.

In each case, CPI discussed the points raised in the attached memo. In particular, CPI stressed the need for the Commission to adopt a forward-looking cost methodology for determining the default compensation amount that long distance carriers should pay to payphone service providers. CPI expressed its concern that the compensation amount is likely to be flowed-through to consumers, causing an increase in telephone consumers' costs of making dial-around calls using pay telephones. CPI believes this would be particularly harmful to consumers given that they often will not know what the charges are for these calls until they receive their bills a month or so after the call is made.

Pursuant to section 1.1206(a)(2) of the Commission's rules, an original and one copy of this notice are being filed with your office. In addition, a copy of these comments is being served on the parties to this proceeding.

Sincerely,

John Windhausen, Jr.

John Windhausen, Jr.
General Counsel

cc: Richard Metzger, Brad Wimmer, John Muleta, Kathy Franco, Paul Galant, Jim Casserly.

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Remand Issues in the Payphone Proceeding (CC Docket No. 96-128) Position of the Competition Policy Institute

Background

The Telecommunications Act of 1996 requires that the Commission –

> *establish a per call compensation plan to ensure that all payphone service providers are fairly compensated for each and every completed intrastate and interstate call using their payphone...*

In its November 1996 decision implementing this provision, the Commission based the compensation rate for coinless payphone calls (such as 800 subscriber calls and access code calls) on the price of deregulated local coin calls. As a result, the largest long distance carriers have been paying 35 cents per call for coinless calls made from payphones. Eventually, the default compensation rate will be the same as the unregulated price of a coin phone call at each payphone. The affected long distance companies have begun to pass this cost on to their 800 number customers and to long distance callers using credit cards.

The Court of Appeals for the District of Columbia overturned several portions of the FCC's decision including: i) basing the compensation rate for coinless calls on the price of deregulated coin calls; ii) exempting small long distance carriers from the requirements of the order during the first year interim period; and iii) using the greater of book value or market value to evaluate the LEC payphone assets transferred to a separate subsidiary.[1]

The Consumer Interest

Coin calls and coinless calls made from payphones are very important for many consumers. Their use by the traveling public is evident; less obvious is the use of these phones by low-income persons as a substitute for basic service and by inmates, military personnel and transient employees like truckers.

CPI thinks telephone consumers will benefit from a more competitive payphone industry. When adopting the payphone language in the Telecommunications Act of 1996, Congress clearly intended that there would be more competition in the payphone business. However, the industry is far from competitive today. We think that deregulating local coin rates, prior to competition, will lead to unnecessarily high rates for coin phone calls. And since the FCC has linked

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1 The Commission also preempted state regulation of local coin phone rates and deregulated those rates effective October 7, 1997. This portion of the order was upheld on appeal.

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payphone compensation to coin phone rates, this means higher rates will follow for long distance users of payphones and for those companies that provide toll-free 800 number service.[2]

In addition to rates for coinless calls, consumers must also be concerned about the availability of toll free 800 number calls from payphones. The reaction of 800 number purchasers to excessive compensation rates will predictably be to block access to 800 numbers from payphones — an action that would reduce the value of both payphones and 800 service.

To serve consumers (and appropriately stimulate competition in the payphone industry) the Commission must do what regulators have always done: attempt to set prices at a level that a competitive market would produce, even when the market is imperfect.

The Correct Basis for Payphone Compensation

CPI agrees with the Commission that rates for payphone compensation should eventually be set by the results of a competitive market. Competition will ensure that the "correct" number of payphones are deployed and that prices for their services will be driven to cost. The difficulty is that the payphone market is not now competitive. While there is competition among PSPs for *locations,* payphones are not competing head-to-head to produce the lowest price for consumers. In fact, many PSPs have locational market power and bid against each other to provide the highest possible commissions for the location owners, driving up consumer prices.

As the Commission knows well, "deregulation" is not the same as "competition." Until the payphone market is competitive, CPI believes that the Commission is on **solid legal and economic grounds** to set payphone compensation based on the costs incurred by the PSPs in providing non-coin calls.

Legal basis: The Telecommunications Act of 1996 requires the Commission to establish a plan that produces payphone compensation at a level that "fairly" compensates payphone service providers for their services. A compensation rate that provides the PSPs with cost recovery (including a fair profit) would produce rates that are "just and reasonable" and which will pass muster as being "fair."

Economic basis: In many cases decided by this Commission, parties often remind the FCC that "competition will drive prices toward costs." It is a tenet of economics that competitive prices are based on cost — there is nothing old-fashioned or retrograde about this concept. Under this economic principle, payphone service providers should recover their costs and only their costs. After all, a competitive market does not countenance a provider that charges prices higher than costs. If that is attempted, a new competitor will enter the market by cutting prices and take the customers.

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2 MCI estimates that payphone compensation at 35 cents will cost consumers $1.3 billion per year.

CPI's Recommendations

- **The Commission should not base payphone compensation on unregulated coin phone rates.** Using unregulated local coin rates as a basis for compensation is inappropriate for two reasons: i) the payphone industry is not sufficiently competitive for unregulated rates to equal a competitive market price; and ii) cost differences between the two types of calls make it unreliable to use coin call prices to set non-coin compensation.[3]

- **The Commission should adopt a cost basis for compensation until the payphone industry is competitive.** As explained above, prices in a competitive market are based on costs. Until the payphone market is sufficiently competitive to allow deregulation of the compensation rate, the Commission should base compensation on a reasonable estimate of the costs of coinless calls. The Commission's record contains substantial evidence about the costs of providing coinless calls. AT&T estimates that the cost is 11 cents per call; other evidence (based on the payphone costs removed by the LECs from regulated rates) suggests that the rate should be 13.7 cents per call.

- **The Commission should apply a changed rate retroactively only if it is legal, feasible and lowers rates to consumers.** There is substantial debate about the Commission's legal authority to order refunds of the interim compensation rate. If the Commission requires refunds of a portion of the compensation paid by IXCs to payphone service providers, CPI believes the overcharges should be returned to the customers of the IXCs if these customers paid higher rates. Neither PSPs nor IXCs should be enriched by excessive rates paid by consumers.

  When deciding whether to apply the interim compensation requirements retroactively to small long distance carriers, the Commission should consider the impact of this change on the compensation rates paid by other IXCs and the feasibility of these smaller companies collecting the revised rate retroactively from their customers.

- **The Commission should maintain its decision to protect ratepayers when determining the value of transferred LEC payphone assets.** The Court of Appeals concluded that the Commission could not protect consumers by using the "higher of market value or book value" when determining the value of LEC payphone assets transferred to a separate subsidiary. The Court reasoned that the price cap LECs had borne the risk of these assets so that this standard is not appropriate.

  CPI believes that the Commission can justify its original decision to use this standard. The Court based its opinion on an imperfect understanding of how price caps work. Under the specific price cap regime used by the Commission, risk does not shift entirely from consumers to the regulated carrier. The Commission should clarify its reasoning and maintain its original decision on this issue.

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3 If the Commission decides to continue to base payphone compensation on coin rates, the Commission must account for the lower cost of a coinless call, compared to a coin call. In a competitive market, such cost differences are reflected in price differences.

Certificate of Service

I, Bridget J. Szymanski, hereby certify that on this sixth day of October, 1997, copies of the foregoing Comments of the Competition Policy Institute were served by hand or by first-class, United States mail, postage prepaid, upon each of the following:

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